DEFI-ANCE? Decentralised finance poses regulatory and cultural challenges

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Attitudes to cryptocurrency decentralised finance (DeFi) polarise between enthusiasm and horror, but most people stand mystified in the middle. The extreme reactions are all provoked by the same feature of DeFi: it lets users conduct transactions without an intermediary firm or regulatory scrutiny. That dichotomy also highlights a cultural hurdle that any plans to grow fintechs within existing official systems may have to cross.

Much of traditional finance essentially runs on a model where firms earn money by being an intermediary. They bundle together lots of deposits, then issue loans to other parties; they are middlemen for investments, international payments and derivatives. Regulators oversee firms and require them to conduct various anti-money laundering (AML) and other financial crime checks, such as verifying customers' identity.

DeFi is different. Parties use a blockchain-linked decentralised app (DApp) to source counterparties for crypto-finance transactions directly, with deals governed by automatically self-executing "smart contracts" running on that blockchain network, which is usually Ethereum. There are, however, no financial services firms in the mix, nor are there any identifiable commercial entities. Most DApps and smart contract-capable blockchains are, like Ethereum, opensource ventures overseen by a fluid community of developers.

"What characterises DeFi is that it is automated, decentralised and non-custodial with no intermediaries," said Suchitra Nair, a partner in Deloitte's EMEA Centre for Regulatory Strategy. "Some traditional finance procedures have one or other of those characteristics but only DeFi combines all three, with the processes codified into smart contracts running on a blockchain."

Rapid growth

DeFi has grown rapidly, from just $622 million locked into DApps in March 2020 to $86.42 billion this September 20. "It is also expanding the things people can do with digital assets," said Tyler Welmans, Deloitte's blockchain practice lead.

"Many product categories are already available in the form of DeFi services: pay, lend, borrow, exchange, insure, to name a few," Welmans said. "Those capabilities will grow further and so will the range of assets available, creating user flexibility and choice. Currently the threat to traditional finance is small by volume, but medium term it's considerable, based on growth trends we are seeing. DeFi is a market of microservices. It unbundles everything: capital, liquidity, derivatives."

Widespread adoption of DeFi would not change the game for firms, it would take away the pitch. To a large extent, getting finance away from traditional firms was DeFi's creators' aim. DeFi user benefits listed on Ethereum's website include fairer access, lower costs, faster transfers and greater privacy, control and product transparency than traditional finance.

"Early DeFi was highly experimental and driven within opensource communities genuinely interested in doing it for the public good, or purely for the kudos associated with such work," Welmans said. "Much of this ethos remains but as DeFi has evolved, commercial models have also matured. For example, a group might create a DApp which incorporates per-transaction fees which accrue to holders of a 'governance token', which can be sold as a means of raising capital."

Value, not surveillance

The DeFi benefits that trouble regulators most are its main attractions for many advocates: user anonymity and the authorities' inability to block payments or freeze accounts. Ethereum's webpage on DeFi makes much of this. It says the organisation "is building an economy based on value, not surveillance" and contrasts DApps' pseudonymous transaction activity with traditional finance, where "financial activity is tightly coupled to your identity".

"No government or company has control over Ethereum. The decentralisation makes it nearly impossible for anyone to stop you receiving payments or using services on Ethereum," the Ethereum DeFi webpage says.

The privacy and the lack of a central body for government agencies to hold accountable has several layers. Both DApps and the smart contract enabled blockchains they connect with are decentralised. Transactions use cryptocurrencies. Some, like the Fintech Circle's USDC stablecoin, are administered by tangible companies but many are also decentralised. They include Monero, which offers heightened anonymity and describes itself as "secure, private and untraceable".

From a regulatory perspective, DeFi creates blatant AML, counter-funding of terrorism, sanctions breach, tax evasion and other financial crime risks. Even though some in the DeFi community would happily be regulated, DeFi operates beyond geographical boundaries and regulators lack a mechanism for regulating in those circumstances, Nair said.

"It's hard to know what regulators can do about DeFi but, notwithstanding a majority of those involved have a privacy agenda, they're not doing it for free," said Sam Tyfield, a partner at the lawyers Shoosmiths. "The code may be opensource but they're making it available to earn revenue for themselves. Regulators could go after the persons seeking to make money but it would be difficult, especially as, if your expenses and revenue are in cryptocurrency, it need never hit a fiat currency bank account."

Difficulties for regulators

Regulators could treat the platform blockchain as a regulatable entity but that poses problems. For example, the Ethereum website is operated by the Ethereum Foundation, which has a three-person executive board. The foundation says it is dedicated to supporting, but does not control, Ethereum and is just part of a "large ecosystem" of organisations, individuals and companies that support Ethereum.

"Like Ethereum, most blockchains DeFi uses are decentralised and backed by foundations," Tyfield said. "It's questionable whether it's possible for one or more persons to have a sufficient level of control of the blockchain to give regulators the degree of responsibility they want to find. You could try to treat the DApp or smart contract coder or protocol designer as the intermediary, but you'd face similar problems."

In practice, regulators may take the same approach they have with other parts of the crypto economy, such as the cryptocurrency exchange Binance, and make it as difficult as possible for DeFi to pick up business. In August, the U.S. Securities and Exchange Commission (SEC) charged two individuals and a Cayman Islands company with making unregistered sales of more than $30 million of securities but the respondents allegedly said they would invest DeFi users' money in real world assets, giving the SEC something to latch onto.

Regulated firms are investigating DeFi's potential. Deloitte's 2021 Global Blockchain Survey found that 44% of financial services respondents foresaw their firm providing access to DeFi platforms in future. Regulated firms' scope for involvement could be limited, however, Tyfield said.

"As DeFi is designed to cut out the intermediary, its primary focus must be on the retail market," Tyfield said. "Regulated firms have requirements that they do business transparently. For example, certain transactions must be conducted on a regulated market."

Cultural divide

The cultural divide is another bar to effective regulation because DeFi developers and regulators see different potential harms. Developers typically focus on combatting technical vulnerabilities while regulators are concerned about money laundering and protecting consumers from scams, Nair said.

There is even a different view of what might constitute effective official oversight, especially given much of the DeFi community's dislike of governmental interference.

"One argument is that much of DeFi is subject to governance by the community, and regulators could participate directly in DApp development and governance communities to represent their interests that way," Welmans said. "Consumer awareness of risks could advantage a DeFi service that says it aligns with certain standards and subjects itself to third-party assessment to verify that it does."

This cultural split may mean that some of the boldest innovations do not sit comfortably in the development sandboxes and other frameworks various regulators run to encourage fintechs. As for regulating DeFi, it may require new forms of national and international regulation, according to Tyfield.

"At the moment, regulators are applying old school rules to a new paradigm," he said.

Complaints Procedure

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